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# Delaware to the Rescue: A Proper Exercise of Deference by the SEC and the Future Implications of *CA, Inc. v. AFSCME*

Joseph Antignani

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## NOTES

# DELAWARE TO THE RESCUE: A PROPER EXERCISE OF DEFERENCE BY THE SEC AND THE FUTURE IMPLICATIONS OF *CA, INC. V. AFSCME*

### I. INTRODUCTION

Ever since the emergence of the modern corporation, some shareholders, known as shareholder activists, have tried to gather more power in the day-to-day management of the firm.<sup>1</sup> Typically, the corporation is managed by a group known as the board of directors, with minimal interference from shareholders.<sup>2</sup> However, the Securities and Exchange Commission (SEC) allows shareholders a chance to influence the corporation via shareholder proposals, which are proposals made by shareholders that are “placed alongside management’s proposals in that company’s proxy [voting] materials for presentation to a vote at an annual or special meeting.”<sup>3</sup> Nevertheless, upon the request of the corporation receiving the proposal, the SEC may exclude such a proposal if it violates “certain procedural requirements or the proposal falls within one of the Rule 14a-8’s [thirteen] substantive grounds for exclusion.”<sup>4</sup>

Usually, the SEC decides whether the proposal violates any of the provisions without help from any outside source.<sup>5</sup> However, that all changed in July 2008 when the SEC certified a request for exclusion made by a corporation to the Delaware Supreme Court pursuant to a new power the court was granted by the Delaware legislature.<sup>6</sup> The case, *CA, Inc. v. American Federation of State, County and Municipal Employees Pension Plan* (AFSCME), was accepted for adjudication by the Delaware Supreme

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1. MELVIN A. EISENBERG, CORPORATION AND OTHER BUSINESS ORGANIZATIONS 154–55 (9th ed. 2005) (stating that in 1932, Adolph A. Berle and Gardiner C. Means gave rise to the modern corporation when their influential paper, *The Modern Corporation and Private Property*, argued that ownership and control in a corporation should be separate from one another. The work is widely adopted today).

2. *Id.* at 106.

3. *Id.* at 304–05 (quoting SEC Staff Legal Bulletin No. 14A (2002)). Details about how shareholder proposals work, and the company’s ability to exclude them under Rule 14a-8 of the federal proxy rules, are discussed in Part II.

4. Paul S. Atkins, Commissioner, U.S. Sec. & Exch. Comm’n, Address at the U.S. Chamber of Commerce: Shareholder Rights, the 2008 Proxy Season, and the Impact of Shareholder Activism (July 22, 2008).

5. *Id.*

6. The ability for the SEC to certify to the Delaware Supreme Court is codified in Del. Const. art. IV, § 11(8). The author worked at the SEC, in the Chief Counsel’s office for the Division of Corporation Finance, during the period in which the questions of law presented in the *CA, Inc.* no-action request were certified and decided by the Delaware Supreme Court.

Court and decided two weeks later in a landmark opinion.<sup>7</sup> Relying on the court's opinion, the SEC excluded the proposal and thus, for the first time in its history, decided an issue that arose under the federal proxy rules by directly relying on the decision of a state court.<sup>8</sup>

The court's decision in *CA, Inc.* has raised eyebrows for two reasons. First, federalism questions have emerged regarding the SEC's ability to certify questions of law to outside jurisdictions in order to help it make decisions under federal securities laws. Second, the court's decision is important because it affects Delaware law. Since *CA, Inc.* was a Delaware decision, the case is likely to influence the corporate law jurisprudence of other states.<sup>9</sup> *CA, Inc.* will also affect a majority of publicly traded corporations since Delaware is their choice for incorporation.<sup>10</sup> Thus, this note will have a dual purpose: (1) to analyze the federalism aspects of the SEC's decision to certify two questions of law to the Delaware Supreme Court and (2) to determine what impact the *CA, Inc.* case will have on Delaware's (and presumably other states') corporate law jurisprudence as it relates to the ability of shareholders to affect a corporation via the bylaw amendment process. Part II of this note describes the SEC's role under Rule 14a-8 of the 1934 Securities Exchange Act ('34 Act).<sup>11</sup> Part III describes the power of the SEC to certify questions of law to the Delaware Supreme Court. Part IV of this note explores the facts and background of the *CA, Inc.* case including the actual shareholder proposal submitted by AFSCME, briefly discusses the decision and rationale of the Delaware Supreme Court and introduces what the case stood for, both from a federalism perspective and for Delaware Corporation Law. Part V focuses on why the SEC was criticized for certifying this federal proxy rule case to the Delaware Supreme Court, and responds to the criticisms specifically advanced by Professor J. Robert Brown, a corporate law scholar.<sup>12</sup> The section concludes with this author's defense of the SEC's actions, and a suggestion for how all states can improve their corporate law. Part VI of this note discusses the affects of the *CA, Inc.* case on Delaware corporate law and reviews the reactions of scholars and commentators to the decision. In addition, it

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7. See *CA, Inc. v. Am. Fed'n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227 (Del. 2008). The opinion and its future implications are discussed *infra* in Part VI.

8. See *CA, Inc.*, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 516 at \*1, discussed *infra* in Part IV.

9. See Delaware Supreme Court to SEC: Bring It On, <http://blogs.wsj.com/law/2007/05/21/delaware-supreme-court-to-sec-bring-it-on/> (May 21, 2007, 15:32 EST) (stating that the Delaware Supreme Court is influential).

10. More than 50% of all publicly-traded companies in the United States, including 63% of the Fortune 500, have chosen Delaware as their legal home. Delaware Dept. of St.: Div. of Corp., <http://www.corp.delaware.gov/aboutagency.shtml> (last visited Mar. 1, 2009).

11. 17 C.F.R. § 240.14a-8 (2008).

12. Professor Brown is a Corporate Governance and Business Law Professor at the University of Denver, Sturm College of Law. See Professor Jay Brown, <http://law.du.edu/index.php/profile/jay-brown>.

explains why the case is a significant loss for shareholders outside of election related bylaw amendments.

## II. RULE 14A-8 OF THE EXCHANGE ACT

The '34 Act was created because "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets [involve a] national public interest . . . [making it necessary to] provide for regulation and control of such transactions and of practices and matters related thereto . . . to insure the maintenance of fair and honest markets in such transactions."<sup>13</sup> Rule 14a-8 of the '34 Act allows for shareholders who meet certain guidelines to submit proposals to companies in which they hold shares.<sup>14</sup> However, Rule 14a-8 also allows companies to exclude such proposals under various grounds.<sup>15</sup> Thus, if a shareholder submits a proposal to a company, the company is allowed to exclude the proposal from its annual meeting if it believes the '34 Act allows for it. However, in order to exclude the proposal, the company must file a "no-action" request with the SEC's Division of Corporation Finance<sup>16</sup> (Staff), asking them to "concur in the company's view" that the proposal is excludable under Rule 14a-8 of the '34 Act.<sup>17</sup> Although the Staff's decision is not binding,<sup>18</sup> companies rarely, if ever, go against what the Staff says for fear of enforcement action against them by the SEC.<sup>19</sup>

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13. 15 U.S.C. § 78(b) (2006). Other goals of the '34 Act were to govern "transactions by officers, directors, and principal security holders, to require appropriate reports to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the [f]ederal taxing power, to protect and make more effective the national banking system and Federal Reserve System." 15 U.S.C. § 78(b).

14. 17 C.F.R. § 240.14a-8(b) (2008) ("[I]n order to be eligible to submit a proposal, [shareholders] must have continuously held at least \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date you submit the proposal. [Shareholders] must continue to hold those securities through the date of the meeting.").

15. There are two types of exclusions that a company can use in order to invalidate a shareholder proposal: procedural and substantive. Procedural exclusions are located in 17 C.F.R. § 240.14a-8(b)-(e). Substantive exclusions are located in 17 C.F.R. § 240.14a-8(i)(1)-(i)(13).

16. The Division of Corporation Finance of the SEC has the power to interpret and decide questions under Rule 14a-8. See SEC.gov, No-Action Letters, <http://sec.gov/divisions/corpfin/cf-noaction/14a-8.shtml> (last visited Apr. 13, 2009).

17. SEC Staff Legal Bulletin No. 14 (2001), available at <http://sec.gov/interp/legal/cfslb14.htm>.

18. See *id.* ("[T]he no-action responses only reflect our [the Staff's] informal views regarding the application of Rule 14a-8. We do not claim to issue 'rulings' or 'decisions' on proposals that companies indicate they intend to exclude, and our determinations do not and cannot adjudicate the merits of a company's position with respect to a proposal").

19. See Cooley Godward Kronish LLP, *CooleyAlert! Shareholder Proposals: What You Need to Know Now*, 1, 1 (2004), [http://www.cooley.com/files/tbl\\_s24News/PDFUpload152/780/ALERT\\_Shareholder\\_Proposal.pdf](http://www.cooley.com/files/tbl_s24News/PDFUpload152/780/ALERT_Shareholder_Proposal.pdf) (stating that "the company may not exclude the proposal

Under Rules 14a-8(i)(1) and (i)(2), the SEC has the power to grant no-action relief to a company if the shareholder's proposal is "not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization"<sup>20</sup> or, "if implemented, [would] cause the company to violate any state, federal, or foreign law to which it is subject."<sup>21</sup> Essentially, Rules 14a-8(i)(1) and (i)(2) ask the SEC to interpret the law of the company's state of incorporation and decide whether the state's corporate law would allow for the exclusion of such proposal.<sup>22</sup> Traditionally, the SEC's role under Rules 14a-8(i)(1) and (i)(2) was similar to that of a federal court applying state law in a diversity jurisdiction case, with one key difference: the lack of power to certify questions of law to the relevant state court for interpretation and decision.<sup>23</sup>

### III. THE SEC'S CERTIFICATION ABILITY

In 2007, the SEC received the power to certify questions of law to a state court when Delaware, wanting the SEC to "advance a direct interpretation of Delaware law,"<sup>24</sup> amended its state constitution to allow the SEC to certify questions of law directly to the Delaware Supreme Court.<sup>25</sup> The Delaware certification provision allows the SEC to ask the Delaware Supreme Court any questions about Delaware state law. This is helpful for the SEC in situations where its decision requires an application of Delaware state law. While some hailed the move as potentially "the most

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unless it has received a response from the SEC indicating that it will not take any enforcement action against the company if the shareholder proposal is omitted."'). However, it should be noted that all parties to a no-action request have the ability to appeal the Staff's decision to the Federal District Court.

20. 17 C.F.R. § 240.14a-8(i)(1) (2008).

21. 17 C.F.R. § 240.14a-8(i)(2).

22. See 17 C.F.R. § 240.14a-8(i)(1) & (i)(2).

23. In a case brought on diversity jurisdiction grounds, federal courts generally apply the law the state court in the state of the diversity filing would have applied. See generally *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938). This is similar to the SEC which applies the law of the state in which the company is incorporated (i.e. if the company is incorporated in New York, then the SEC will apply the corporate law the New York state courts would have applied). However, unlike the SEC in non-Delaware cases, federal judges may go "straight to those responsible for declaring state law [and] certify novel questions of state law directly to the state's highest court." Wendy L. Watson, Mckinzie Craig & Daniel Orion Davis, *Federal Court Certification of State-Law Questions: Active Judicial Federalism*, JUST. SYS. J. 1, 1 (2007), available at [http://findarticles.com/p/articles/mi\\_qa4043/is\\_200701/ai\\_n18755748?tag=untagged](http://findarticles.com/p/articles/mi_qa4043/is_200701/ai_n18755748?tag=untagged).

24. Delaware Supreme Court to SEC: Bring It On, *supra* note 9.

25. DEL. CONST. art. IV, § 11(8) ("The Supreme Court shall have jurisdiction . . . [t]o hear and determine questions of law certified to it by . . . the United States Securities and Exchange Commission.").

important development in Delaware corporate law,”<sup>26</sup> others were far less enthused about the possibility of federal deference to a state court.<sup>27</sup>

Following the constitutional amendment, AFSCME introduced a proposal<sup>28</sup> to CA, Inc. (CA) for inclusion in its 2008 Annual Meeting of Shareholders.<sup>29</sup> CA, pursuant to Rules 14a-8(i)(1), (i)(2), (i)(3),<sup>30</sup> and (i)(8),<sup>31</sup> asked the Staff to concur in their judgment that the proposal was excludable.<sup>32</sup> While the Staff refused to exclude the proposal under (i)(3) and (i)(8),<sup>33</sup> it was unsure whether CA met its burden under (i)(1) and (i)(2) to exclude AFSCME’s proposal.<sup>34</sup> Since CA was a company incorporated in Delaware,<sup>35</sup> the SEC decided to certify two questions of law concerning CA’s no-action request to the Delaware Supreme Court using the new power granted to it approximately one-year prior.<sup>36</sup> The Delaware Supreme Court accepted certification<sup>37</sup> and decided the case in sixteen days,<sup>38</sup> ultimately concluding that the proposal was illegal under Delaware state law.<sup>39</sup> Consequently, “having the guidance of the Delaware decision, the SEC staff notified CA on July 17, 2008, that the proposal could be excluded on the basis of Rule 14a-8(i)(2).”<sup>40</sup>

Immediately following the case, the SEC was attacked by scholars who believed it was improper for the SEC to decide a federal issue by exercising

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26. SEC to Certify Questions to Delaware Supreme, [http://www.theconglomerate.org/2007/05/sec\\_to\\_certify\\_.html/](http://www.theconglomerate.org/2007/05/sec_to_certify_.html/) (May 22, 2007).

27. As Predicted: The SEC and the Further Denial of Shareholder Access, <http://www.theracetothetbottom.org/the-sec-governance/as-predicted-the-sec-and-the-further-denial-of-shareholder-a.html> (July 1, 2008, 13:00) (calling the SEC’s certification ability “a very bad idea for so many reasons.”).

28. See *CA, Inc., v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227, 227 (Del. 2008).

29. *CA, Inc.*, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 495 at \*1.

30. Rule 14a-8(i)(3) allows for proposal exclusion if the “proposal or supporting statement is contrary to any of the Commission’s proxy rules, including § 240.14a-9, which prohibits materially false or misleading statements in proxy soliciting materials.” 17 C.F.R. 240.14a-8(i)(3) (2008).

31. Rule 14a-8(i)(8) allows for proposal exclusion if the “proposal relates to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election.” 17 C.F.R. 240.14a-8(i)(8).

32. Request of *CA, Inc.*, 2008 SEC No-Act. LEXIS 495, at \*49.

33. *Id.* at \*1.

34. *Id.* at \*2.

35. This information is available via the SEC IDEA database, <http://sec.gov/cgi-bin/browse-edgar?company=&CIK=CA&filenum=&State=&SIC=&owner=include&action=getcompany>.

36. 2008 SEC No-Act. LEXIS 495, at \*2.

37. Order accepting certification from the SEC, *CA, Inc., v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, No. 329, 2008 1, 3 (Del. 2008), available at <http://blogs.law.harvard.edu/corpgov/files/2008/07/corrected-order.pdf>.

38. The Delaware Supreme Court accepted certification on July 1, 2008. *Id.* The case was decided on July 17, 2008. See *CA, Inc., v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227, 227 (Del. 2008).

39. *CA, Inc.*, 953 A.2d at 227.

40. *Atkins*, *supra* note 4.

deference to a state court.<sup>41</sup> However, *CA, Inc.* should not be looked at solely through the prism of federalism philosophy and debate. The actual substantive decision of the case is one that has inspired passionate arguments from numerous scholars, commentators, law firms and experts on the topic, many who disagree as to what exactly the Delaware Supreme Court decided. Were all election bylaws therefore good, so long as they contained an express fiduciary out clause?<sup>42</sup> Could shareholders affect a corporation via bylaws for other types of corporate governance issues?<sup>43</sup> The *CA, Inc.* decision left these questions open to interpretation.

#### IV. FACTS AND BACKGROUND OF *CA, INC. V. AFSCME*

On April 18, 2008, CA submitted six copies of its no-action request<sup>44</sup> asking the Staff to exclude a proposal presented to it by AFSCME. The relevant part of the proposal reads as follows:

The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the "Nominator") for reasonable expenses ("Expenses") incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors, (c) stockholders are not permitted to cumulate their votes for

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41. As Predicted: The SEC and the Further Denial of Shareholder Access, *supra* note 27 (calling the SEC's certification ability "a bad idea for so many reasons").

42. Professor Brown argues that the case has "dramatically broaden[ed] the types of bylaws that now must be excluded under Rule 14a-8." As Predicted: The SEC and the Further Denial of Shareholder Access (The Anticipated Result) (Part 18), <http://www.theracetothetbottom.org/the-sec-governance/as-predicted-the-sec-and-the-further-denial-of-shareholder-a-71468.html> (July 18, 2008 06:14). Another blogger maintains that the case is a "huge win" for shareholders inside the election process, but "negative for all other types of stockholder-adopted bylaws." *CA v. AFSCME: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, [http://www.deallawyers.com/blog/archives/2008\\_07.html](http://www.deallawyers.com/blog/archives/2008_07.html) (July 18, 2008 07:29 EST). However, Larry Ribstein argues "the court made it clear that it was not deciding the issue as a matter of policy, and left insurgents alternative procedures. Thus, the court was careful to present itself as a pragmatic forum that would hear the shareholders out on a case by case basis." Delaware Responds to the Certified Questions, <http://busmovie.typepad.com/ideoblog/2008/07/delaware-respon.html> (July 17, 2008 20:19 EST) [hereinafter, Ribstein, Delaware Responds]. See also Barry H. Genkin & Keith E. Gottfried, *Delaware Supreme Court Holds That A Bylaw Mandating Reimbursement Of A Dissident Shareholder's Proxy Solicitation Expenses Is A Proper Subject For Unilateral Shareholder Action But As Proposed Violates Delaware Law*, Aug. 28, 2008, available at <http://www.blankrome.com/index.cfm?contentID=37&itemID=1655> ("[W]hile [the] decision can be seen as a significant victory for dissident and activist shareholders, it leaves many questions unanswered.").

43. See sources cited *supra* note 42.

44. When a company requests that the Staff concur in its judgment that it may exclude the proposal under Rule 14a-8, it must submit six copies of its response pursuant to 17 C.F.R. § 14a-8(j)(2) (2008).

directors, and (d) the election occurred, and the Expenses were incurred, after [the] bylaw's adoption. The amount paid to a Nominator under this bylaw in respect of a contested election shall not exceed the amount expended by the corporation in connection with such election.<sup>45</sup>

CA asked the Staff to concur in its judgment that the proposal violated Rules 14a-8(i)(1), (i)(2), (i)(3) and (i)(8).<sup>46</sup> Furthermore, CA furnished a legal opinion<sup>47</sup> from the law firm Richards, Layton and Finger (RLF), stating the proposal, "if adopted, would cause [CA] to violate [s]ection 141(a) of the [Delaware] General Corporation Law (DGCL)."<sup>48</sup> Section 141(a) of the DGCL requires that the corporation be managed by the board of directors, subject to limitations and grants of power stated in the certificate of incorporation.<sup>49</sup> Since CA's Certificate of Incorporation clearly stated that the management and conduct of the business "shall be vested in its Board of Directors," RLF asserted the "Certificate of Incorporation does not contemplate management by the stockholders or anyone other than the Board of Directors of the Company."<sup>50</sup> Thus, RLF concluded that AFSCME's proposal could not be legal under the DGCL because the "[p]roposed [b]ylaw would require that the Board relinquish its power to determine what expenses should and should not be reimbursed to stockholders, instead requiring that the Board reimburse all proxy solicitation expenses that meet the criteria set forth in the [p]roposed [b]ylaw."<sup>51</sup>

On May 21, 2008, AFSCME responded to CA's no-action request by submitting a legal opinion of its own to the Staff, explaining why it felt that the proposal submitted to CA was legal under the DGCL.<sup>52</sup> In support of AFSCME's position, its counsel, Grant & Eisenhofer (G&E), asserted that the proposal was legal under the DGCL because "shareholders have the power to enact bylaws."<sup>53</sup> Furthermore, G&E argued that language in section 109(b) of the DGCL strengthened this argument.<sup>54</sup> Section 109(b) of the DGCL states that "bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of

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45. *CA, Inc., v. Am. Fed'n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227, 227 (Del. 2008).

46. Request of CA, Inc., CA, Inc., SEC No-Action Letter, 2008 SEC No-Act. LEXIS 495, at \*49.

47. Whenever a company tries to exclude a proposal "based on matters of state or foreign law" (i.e., under (i)(1) or (i)(2)), "a supporting opinion of counsel" is required. 17 C.F.R. § 240.14a-8(j)(2)(iii).

48. Request of CA, Inc., 2008 SEC No-Act LEXIS 495, at \*60.

49. DEL. CODE ANN. tit. 8 § 141(a) (2008).

50. Request of CA, Inc., 2008 SEC No-Act LEXIS 495, at \*76 (*quoting* art. SEVENTH, § 1 of CA, Inc. Certificate of Incorporation).

51. *Id.* at \*78.

52. *See generally* Response of AFSCME, 2008 SEC No-Act LEXIS 495.

53. *Id.* at \*23.

54. *Id.* at \*23-24.



the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.”<sup>55</sup> Therefore, G&E concluded AFSCME’s bylaw was valid since Delaware law would allow for “a Corporation to expend corporate funds to reimburse successful nominators.”<sup>56</sup>

After CA provided an answer to AFSCME’s response that reiterated its initial arguments, the Staff issued its initial no-action response to the parties involved.<sup>57</sup> Writing for the Staff, Thomas J. Kim<sup>58</sup> concluded that the SEC would have to certify questions of law to Delaware to decide the no-action request, to determine if the “proposal is a proper subject for action by shareholders as a matter of Delaware law, and . . . whether the proposal, if adopted, would cause CA to violate any Delaware law to which it is subject.”<sup>59</sup> Thus, the SEC was going to defer to a state court in order to answer a no-action request for the first time ever, via the power granted to it by Delaware in 2005.<sup>60</sup> By asking whether the “proposal is a proper action for shareholders,” the SEC was looking for an answer to Rule 14a-8(i)(1).<sup>61</sup> In addition, in asking “whether the proposal, if adopted, would cause CA to violate any Delaware Law,” the SEC was looking for an answer to Rule 14a-8(i)(2).<sup>62</sup> Concluding that “important and urgent reasons” existed for an “immediate determination of the questions certified,” the Delaware Supreme Court accepted the certified questions on July 1, 2008.<sup>63</sup>

On July 16, 2008, after briefs were submitted and oral arguments conducted,<sup>64</sup> Justice Jack B. Jacobs, writing for the court *en banc*,<sup>65</sup> answered both questions in the affirmative.<sup>66</sup> According to the court, the proposal was a proper action because corporate expenditures do not override the basic, fundamental right of shareholders to “facilitate the [ability to participate in selecting contestants to the Board of Directors] by proposing a bylaw that would encourage candidates other than [management’s] nominees to stand for election. [AFSCME’s proposal]

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55. DEL. CODE ANN. tit. 8 § 109(b) (2008).

56. Response of AFSCME, SEC No-Action Letter, 2008 SEC No-Act LEXIS 495, at \*26.

57. See 2008 SEC No-Act. LEXIS 495.

58. Thomas J. Kim is the Chief Counsel & Associate Director for the Division of Corporate Finance. *Id.* at \*2.

59. *Id.*

60. *Id.* at \*1.

61. This is what the language of Rule 14a-8(i)(1) mandates. See 17 C.F.R. 240.14a-8(i)(1) (2008).

62. This is what the language of Rule 14a-8(i)(2) mandates. See 17 C.F.R. 240.14a-8(i)(2).

63. Order accepting certification from the SEC, *CA, Inc., v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, No. 329, 2008 1, 3 (Del. 2008), available at <http://blogs.law.harvard.edu/corpgov/files/2008/07/corrected-order.pdf>.

64. Briefs were submitted on July 7, 2008. Oral arguments were held on July 9, 2008. *Id.*

65. Typically, the Delaware Supreme Court sits in panels of three Justices. Del. Sup. Ct. R. 4(c).

66. *CA, Inc., v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227, 237, 240 (Del. 2008).

accomplish[es] [this] by committing the corporation to reimburse the election expenses of shareholders whose candidates are successfully elected.”<sup>67</sup>

Nevertheless, the court went on to conclude that AFSCME’s bylaw provision was illegal because, when looking at the proposal abstractly,<sup>68</sup> AFSCME’s proposal “would violate the prohibition, which our decisions have derived from [s]ection 141(a), against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders.”<sup>69</sup> If this were allowed, a breach of the board of directors’ fiduciary duty would ensue.<sup>70</sup>

The Delaware Supreme Court’s decision of “split[ting] the baby”<sup>71</sup> enabled the SEC to finally give a conclusive answer to CA’s request for exclusion.<sup>72</sup> On the same day the Delaware Supreme Court declared the proposal invalid, Mr. Kim wrote to the parties involved and told them that due to the Delaware Supreme Court’s decision, CA would be allowed to exclude the proposal.<sup>73</sup> Consequently, CA’s no-action request was resolved. However, debate on the case had just begun.

## V. THE REACTION TO THE SEC’S CERTIFICATION

Not all scholars agree that the *CA, Inc.* case was handled correctly by the SEC. For example, Professor J. Robert Brown, an expert on corporate law and governance and a teacher at the Sturm College of Law at the University of Denver has criticized the SEC’s decision to certify questions of law that arise under Rule 14a-8 directly to the Delaware Supreme Court.<sup>74</sup> However, Professor Brown’s criticism is incorrect. The SEC’s decision to certify two questions to the Delaware Supreme Court was a proper and necessary exercise of deference to state law under the federal proxy rules. Although the SEC has the power to certify questions to the Delaware Supreme Court, it did not have to.<sup>75</sup> The SEC could have refused to exclude the proposal and allow the parties to litigate the case in state

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67. *Id.* at 237.

68. The court explained that “[t]he certified questions [before it] request a determination of the validity of [AFSCME’s proposal] in the abstract. Therefore, in response to the second question, we must necessarily consider any possible circumstance under which a board of directors might be required to act.” *Id.* at 238.

69. *Id.* at 240.

70. *Id.* at 238, 240.

71. *CA v. AFSCME: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, *supra* note 42.

72. *CA, Inc.*, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 516, at \*1.

73. *Id.* at \*1–2.

74. As Predicted: The SEC and the Further Denial of Shareholder Access, *supra* note 27.

75. The SEC is not obligated to certify questions of law to the Delaware Supreme Court. The SEC’s power is unilateral. *See* DEL. CONST. art. IV, § 11(8).

court if they wanted to.<sup>76</sup> Instead, the SEC decided to certify in order to get a proper interpretation of Delaware law, enabling the Staff to obtain accurate answers to Rules 14a-8(i)(1) and (i)(2).<sup>77</sup>

#### A. RESPONDING TO PROFESSOR BROWN

According to Professor Brown, the SEC's decision to certify questions of law to Delaware is nothing more than an "approach[] designed to renege" on a promise to not exclude election-related proposals that have been consistently allowed by the Staff.<sup>78</sup> Professor Brown argues that the SEC's decision to certify questions of law to Delaware in the *CA, Inc.* no-action request was "unnecessary,"<sup>79</sup> ill advised as a "matter of policy,"<sup>80</sup> and a "back door effort by the staff to restrict other types of proposals designed to increase the ability of shareholders to elect directors."<sup>81</sup>

First, Professor Brown argues that the SEC should *never* certify questions of law to the Delaware Supreme Court because it is unnecessary.<sup>82</sup> According to Professor Brown, an "alternative mechanism exists for testing the legality of [proposals]"<sup>83</sup>—the Staff can deny the company's request for no-action relief and allow the company to litigate the matter in Delaware if it wants to.<sup>84</sup> Since the SEC can decide a federal issue, while at the same time the parties to the action can take proper recourse via the state court system, "no reason" exists to use the certification power granted by Delaware to the SEC.<sup>85</sup>

Although Professor Brown is correct when he states that his "alternative mechanism" is a method by which proposals can be presented to the state

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76. This is exactly what Professor Brown says the SEC should have done. *See As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27.

77. *See CA, Inc.*, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 495, at \*1–2.

78. Responding to a "decision of the U.S. Court of Appeals for the Second Circuit that did not defer to the [SEC's] longstanding interpretation of [Rule 14a-8(i)(8)]", Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 34-56914, 72 Fed. Reg. 70450 (Dec. 11, 2007), *available at* <http://www.sec.gov/rules/final/2007/34-56914.pdf>, the "SEC adopted amendments to Rule 14a-8(i)(8) that included extremely broad language" that many feared would be used to exclude proposals relating to a director election that prior thereto were consistently allowed in. *As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27. However, the SEC assured the public that such proposals would continue to be allowed. Professor Brown feels that while such proposals will be permitted under an (i)(8) analysis, the certification power is just a backhanded way of getting the proposal excluded under (i)(1) or (i)(2) by having the Delaware Supreme Court do it for them. Thus, according to Professor Brown, the SEC is *de facto* excluding the proposal and "reneging on their promise." *As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27.

79. *As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27.

courts,<sup>86</sup> if such mechanism was adopted when the SEC had the ability to certify questions of law directly to the pertinent state court, Rules 14a-8(i)(1) and (i)(2) would be effectively rendered meaningless. Proposals that would unquestionably be excluded under Rule 14a-8 (with the aid of a state court's opinion) would be allowed in. Other requests, such as those that touched upon an unsettled state law issue, would automatically be denied no-action relief, since the company would be unable to carry the burden necessary to exclude a proposal under the federal proxy rules.<sup>87</sup> By not exercising its certification ability, the SEC would be wasting its ability to get a definitive determination from the company's state of incorporation. More importantly, the SEC would not be interpreting Rule 14a-8 under Professor Brown's method in the best way possible because the SEC would be denying companies and shareholders alike direct access to the relevant state court, the Delaware Supreme Court—the court with the ability to bring finality to an unsettled area of Delaware law.<sup>88</sup> Although Professor Brown's method is one way of resolving issues like the one presented in the *CA, Inc.* no-action request, the SEC's certification ability is better.

Professor Brown also asserts that the SEC's decision to certify questions of law to the Delaware Supreme Court is ill-advised as a matter of policy.<sup>89</sup> According to Professor Brown, the "Commission should not be in the position of having its interpretation decided by the pro-management Delaware courts."<sup>90</sup> Instead, Professor Brown asserts that the SEC, being the federal agency in charge of interpreting Rule 14a-8 of the '34 Act, should only rely on itself for deciding issues arising under Rule 14a-8.<sup>91</sup>

Although it is true that Delaware effectively decided the Rule 14a-8(i)(1) and (i)(2) questions in the *CA, Inc.* no-action request,<sup>92</sup> the purpose

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86. The SEC still uses this method in non-Delaware no-action requests. See Atkins, *supra* note 4.

87. Professor Brown's "alternative mechanism" is the proper method to use when the SEC does not have the ability to certify questions of law to the company's state of incorporation. However, when the SEC has a process to get a correct state interpretation, that process should be used. Whether other states should follow Delaware's lead and grant the SEC the ability to certify questions to its highest court is discussed *infra* Part V.B.

88. The SEC's job is to determine how a state court would decide the no-action request presented to them. See 17 C.F.R. § 240.14a-8(i)(1) & (i)(2) (2008). Thus, if the SEC can get an answer from the court with the ability to interpret such mandate, an argument can be made that the SEC must attempt to receive an answer from that court.

89. As Predicted: The SEC and the Further Denial of Shareholder Access, *supra* note 27.

90. *Id.*

91. See generally *id.*

92. Technically, all Delaware decided was the proposal's legality under state law. The SEC then took that decision and applied it to Rules 14a-8(i)(1) and (i)(2). However, by deciding the state law question, Delaware effectively dictated to the SEC how they should come out on the Rule 14a-8(i)(1) and (i)(2) issue. Nevertheless, the focus should not be on whether the Delaware Supreme Court's opinion had the de facto effect of deciding the no-action request, but rather whether the SEC's interpretation of Rules 14a-8(i)(1) and (i)(2) violated principles of federalism. It is the position of this Note that it did not, since, by its very nature, Rules 14a-8(i)(1) and (i)(2) require deference to other law.

of Rules 14a-8(i)(1) and (i)(2) is for the SEC to defer to state law. It is a fact that “[i]nvariably, proxy regulation intrudes to a certain extent on state regulation of shareholder voting rights.”<sup>93</sup> This is because “corporations are creatures of state law and . . . state law remains [the main basis for corporate governance rules].”<sup>94</sup> Thus, if the SEC decided the issue when an alternative method existed by which the SEC could get a direct answer, it would be overstepping the “authority that has been clearly delegated to it by Congress.”<sup>95</sup>

In addition, while the *CA, Inc.* case does raise questions of federalism, it does not do so in the usual sense. In the classic federalism case, the federal and state government battle over whose laws govern a particular area of the law.<sup>96</sup> The two sides each believe that their rule is the governing one.<sup>97</sup> Here, the exact opposite situation is present. Instead of the state government and the federal government bickering with each other over which law governs, the SEC and Delaware are working in tandem, as Delaware is relying on the SEC to certify unsettled questions of law, while the SEC is relying on Delaware to render an opinion so the SEC can decide the no-action request presented to it.<sup>98</sup> Because the SEC had already interpreted Rules 14a-8(i)(1) and (i)(2) in the *CA, Inc.* no-action request to mean that further clarification was needed from the Delaware Supreme Court to answer the no-action request presented to them,<sup>99</sup> the SEC’s interpretation of Rules 14a-8(i)(1) and (i)(2) was not decided by the Delaware courts. Asking members of the Staff, whose expertise lays outside the realm of complex questions of state law,<sup>100</sup> to decide the issue for themselves when a process exists whereby they can receive an answer from state courts, would go against the mandate of Rules 14a-8(i)(1) and (i)(2). Therefore, the SEC’s certification to Delaware was a correct action. In

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93. ProfessorBainbridge.com, *CA v. AFSCME: Should the SEC Have Raised the Question?*, <http://www.professorbainbridge.com/> (July 13, 2008), (follow “Archive (Calendar) hyperlink; then follow “Previous Year” hyperlink; then follow “July” hyperlink; then follow “CA v. AFSCME: Should the SEC Have Raised the Question?” hyperlink) [hereinafter Bainbridge].

94. *Id.*

95. *Id.*

96. See Kala Ladenheim, *History of U.S. Federalism*, [http://www.cas.sc.edu/poli/courses/scgov/History\\_of\\_Federalism.htm](http://www.cas.sc.edu/poli/courses/scgov/History_of_Federalism.htm) (last visited on Mar. 1, 2009).

97. For an example of a “classic federalism” case, see *South Dakota v. Dole*, 483 U.S. 203 (1987) (where South Dakota sued the federal government for imposing a national liquor age law that was contrary to South Dakota’s liquor age law).

98. This observation is made by synthesizing the grant of certification power given to the SEC by the Delaware Legislature, Del. Const. art. IV, § 11(8), the comments of Myron T. Steele, Chief Justice of the Delaware Supreme Court (stating that the court wanted the SEC to “advance a more direct interpretation of Delaware law”), Delaware Supreme Court to SEC: Bring It On, *supra* note 9, and the actual certification request by the SEC in the *CA, Inc.* no-action request. *CA, Inc.*, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 495, at \*1–2.

99. See 2008 SEC No-Act. LEXIS 495, at \*2.

100. This is why a legal opinion from a law firm with knowledge of the governing state law is required whenever a state law ground (i.e., 14a-8(i)(1) and (i)(2)) is asserted for a proposal’s exclusion.

contrast, it may be Professor Brown's position that would cause a violation of federalism principles to occur, as the SEC would be exercising authority in an area of law generally reserved to the states, when an avenue exists by which they could receive the necessary answer from the state.<sup>101</sup>

The SEC's decision to certify questions of law to Delaware in the *CA, Inc.* case is also supported by *Business Roundtable v. SEC*.<sup>102</sup> In *Business Roundtable*, the SEC adopted a rule barring self-regulatory organizations (SROs)<sup>103</sup> "from listing the stock of a corporation that takes any corporate action 'with the effect of nullifying, restricting or disparately reducing the per share voting rights of [existing common stock holders].'"<sup>104</sup> In an opinion that one scholar refers to as "the most significant evaluation of the scope of the SEC's authority in [the § 14 area to date],"<sup>105</sup> the court unanimously declared the law invalid because it "directly interfere[d] with the substance of what . . . shareholders may enact."<sup>106</sup> The court concluded that the primary purposes of § 14 of the '34 Act are disclosure and enhancement of communication with potential absentee voters.<sup>107</sup> Therefore, if the regulation was allowed, the federalism principle of corporations as "creatures of state law"<sup>108</sup> would have been "severely impinged."<sup>109</sup>

The *Business Roundtable* decision is clear on the authority of the SEC under § 14 of the '34 Act: the SEC will receive maximum deference when it comes to promulgating and interpreting rules that will effect proxy communication and disclosure, but will get minimum deference when other areas are regulated, especially those that are "within the state's purview."<sup>110</sup>

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101. See As Predicted: The SEC and the Further Denial of Shareholder Access, *supra* note 27 (stating that the Commission should have the "staff . . . withdraw the request [and] [l]et the proposal go forward . . . leav[ing] it to the parties to sort it out in the Delaware courts if they think it appropriate.").

102. See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). This case was brought to my attention by Professor Stephen Bainbridge's blog posting. See Bainbridge, *supra* note 93. Professor Bainbridge is a Professor of Law at the UCLA School of Law.

103. Self-regulatory organizations are defined as "non-governmental organization[s] that ha[ve] the power to create and enforce industry regulations and standards. The priority is to protect investors through the establishment of rules that promote ethics and equality. Some examples of SRO's include stock exchanges [e.g., the New York Stock Exchange], the Investment Dealers Association of Canada, and the National Association of Securities Dealers in the United States." Investopedia, Self-Regulatory Organization, <http://www.investopedia.com/terms/s/sro.asp> (last visited Mar. 1, 2009).

104. *Business Roundtable*, 905 F.2d at 407.

105. Bainbridge, *supra* note 93. It should also be noted that Rules such as 14a-8 are promulgated according to their respective section in the '34 Act (i.e. § 14 of the '34 act is enforced by various rules, such as Rule 14a-8 under the Exchange Act.) Accordingly, when § 14 is referred to, it covers the same substantive area that Rule 14a-8 is covering as well.

106. *Business Roundtable*, 905 F.2d at 411.

107. See *id.* at 410.

108. *Id.* at 412 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 469 (1977)).

109. *Business Roundtable*, 905 F.2d at 412.

110. Bainbridge, *supra* note 93.

Thus, it becomes evident that the SEC properly certified questions to the Delaware Supreme Court in the *CA, Inc.* no-action request because AFSCME's proposal touched upon reimbursement of proxy solicitation costs, a traditional state law issue.<sup>111</sup> Under *Business Roundtable*, if the SEC can get an answer from a state court about an unsettled issue of state law, it *must* attempt to defer to the proper state court, since answering the issue on its own would be an exercise of authority not granted to it.<sup>112</sup>

Professor Brown also argues that the SEC improperly certified questions of law to the Delaware Supreme Court in the *CA, Inc.* no-action request because, in doing so, the SEC was trying to "restrict . . . proposals designed to increase the ability of shareholders to elect directors."<sup>113</sup> He asserts that when amendments to Rule 14a-8(i)(8) were made, the type of a proposal like the one at issue in *CA, Inc.* was deemed to be allowed under the proxy rules.<sup>114</sup> Thus, Professor Brown concludes that if the SEC was honest about not excluding shareholder proposals relating to the election of directors, it would not allow Delaware the ability to *de facto* exclude the proposal.<sup>115</sup>

Professor Brown's sentiments about allowing shareholders increased access to proxy ballots is a traditional state law issue because it concerns the election of directors.<sup>116</sup> Thus, bylaw amendments that affect the election of directors are best left to a state court's interpretation, even if that state court may have a bias towards management.<sup>117</sup> Furthermore, while Professor Brown believes the SEC's certification to Delaware is nothing more than a "backhanded attempt" by it to exclude a shareholder proposal concerning an election,<sup>118</sup> the SEC decided the issue under Rule 14a-8(i)(2).<sup>119</sup> In fact, the SEC's refusal to exclude the proposal under Rule 14a-8(i)(8) in *CA, Inc.* was consistent with the SEC's prior statements on the subject.<sup>120</sup> The SEC is not in the business of deciding what should be the

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111. *See id.*

112. A court may not have to accept the SEC's attempt for deferral. *See* DEL. CONST. art. IV, § 11(8) (stating that the Delaware Supreme Court has the power to accept questions from the SEC, but not that it must accept certification). If such a case were to occur, then Professor Brown's "alternative mechanism" would be acceptable.

113. *As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27.

114. *Id.*

115. *Id.*

116. Of course, the SEC has authority to regulate voting procedure under § 14 of the '34 Act. However, in my opinion, once the SEC gets into the realm of how the board is nominated or how a person or slate of candidates can get onto a proxy ballot, then it is violating principles of federalism. *See* Bainbridge, *supra* note 93.

117. Professor Brown believes that Delaware is a pro-management state. *See* *As Predicted: The SEC and the Further Denial of Shareholder Access*, *supra* note 27.

118. *Id.*

119. *CA, Inc.*, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 516, at \*1-2.

120. 2008 SEC No-Act. LEXIS 495, at \*1. Although it may seem that excluding a proposal that was previously approved by the SEC is contradictory at first, it can easily be reconciled. As previously mentioned, the SEC in prior statements only stated that they would not exclude

best policy, or creating federal corporate law.<sup>121</sup> The only job of the SEC under Rules 14a-8 (i)(1) and (i)(2) is to find out what the state law on the subject is and to apply it accordingly.<sup>122</sup> Therefore, the SEC's decision to certify to questions of law in the *CA, Inc.* case was proper.

### **B. OTHER ARGUMENTS IN FAVOR OF THE SEC'S CERTIFICATION POWER**

The SEC's certification ability gives other benefits to all parties involved. One such benefit is economic. Under Professor Brown's "alternative mechanism," a company would have to go through two different court systems in Delaware:<sup>123</sup> the Chancery Court,<sup>124</sup> followed by an appeal to the Delaware Supreme Court.<sup>125</sup> However, under the power given to the SEC by the Delaware state legislature, litigants are directed straight to the Delaware Supreme Court.<sup>126</sup> Thus, not only does the SEC's certification power give a definitive, binding answer to all involved, but it also saves money for litigants by eliminating an additional round of court costs and attorney fees. In the case of corporate litigants (such as CA and AFSCME), every dollar saved by the parties is another dollar available for the corporation and shareholders. While the savings may be trivial for big corporate entities (again, like CA<sup>127</sup> and AFSCME<sup>128</sup>), such savings might prove significant if the litigants were a small start-up corporation and an individual, flesh-and-blood shareholder who made the proposal.

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proposals, like the one proposed by AFSCME, under Rule 14a-8(i)(8). However, the SEC never stated what its answer would be under 14a-8(i)(1) and (i)(2) because such an answer is impossible to formulate in the ever-changing world of a state's corporate law jurisprudence. Thus, the SEC's decision is consistent.

121. See *Business Roundtable v. SEC*, 905 F.2d 406, 412 (D.C. Cir. 1990) (stating that federal corporate law violates an area traditionally governed by the states).

122. See *id.*

123. The number of courts that would have to be encountered under Professor Brown's alternative method would vary from state to state. In Delaware, this type of claim would start in the Court of Chancery and then be appealed to the Delaware Supreme Court. Thus, the jurisdiction of two courts would be invoked.

124. The Delaware Court of Chancery makes "determination[s] of disputes involving the internal affairs of the thousands upon thousands of Delaware corporations and other business entities through which a vast amount of the world's commercial affairs is conducted." Delaware Court of Chancery Homepage, <http://courts.delaware.gov/Courts/Court%20of%20Chancery/> (last visited Mar. 1, 2009).

125. "In civil cases, the Delaware Supreme Court has jurisdiction to accept appeals from final orders issued by the judges (not commissioners or masters) of the Court of Chancery." Filing an Appeal in the Supreme Court of the State of Delaware, <http://courts.delaware.gov/How%20To/Appeals/?SupremeCitizensGuide.htm> (last visited Mar. 1, 2009).

126. See DEL. CONST. art. IV, § 11(8).

127. CA, Inc. had a gross revenue of \$4.277 Billion and a net profit of \$500 Million in 2007. CA, Inc., Annual Report (Form 10-K), at 27 (May 23, 2008).

128. The AFSCME Employee Pension Fund has been described as being worth a trillion dollars. Supreme Court Decides SEC-presented Delaware Bylaw Issue (July 17, 2008), <http://www.delawarelitigation.com/articles/delaware-supreme-court-updates/>.



Another advantage of the SEC's power to certify is the ability of the Delaware courts to address corporate law questions faster and more efficiently.<sup>129</sup> Allowing the SEC to certify questions of law to the Delaware Supreme Court gives the Delaware Supreme Court the ability to render an opinion on a subject over which it otherwise would have to wait to acquire jurisdiction.<sup>130</sup> The "expedited process" allows for clarification of the laws and gives guidance to the lower Delaware courts, unifying their decisions. This unification factor is especially important for Delaware, whose corporate law jurisprudence is often relied upon by courts in different jurisdictions.<sup>131</sup>

Prior to being given the ability to certify questions of law to the Delaware Supreme Court, the SEC often deferred to the company's legal opinion in no-action requests where the only opinion submitted was provided by the company.<sup>132</sup> When the SEC not only "receive[d] a well-reasoned legal opinion from the company, but also receive[d] an equally well-reasoned legal opinion from [a] shareholder reaching the opposite conclusion" the SEC usually ruled that a proposal could not be excluded.<sup>133</sup> This is because "Rule 14a-8(g) places the burden . . . of demonstrating that exclusion is warranted" on the company.<sup>134</sup> As a result, the Staff did not "previously . . . permit[] exclusion when there [were] dueling legal opinions."<sup>135</sup> Under this line of reasoning, it is fair to say that AFSCME's proposal would not have been excluded under the SEC's "old" method of Rule 14a-8 interpretation and decision making.<sup>136</sup> Thus, the benefit of the certification power has already been demonstrated, as the SEC under the old

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129. This observation is made simply from common knowledge. The Delaware Supreme Court took sixteen days to decide *CA, Inc.*, from certification by the SEC. If the parties had to go through the entire Delaware court structure, from the Court of Chancery through the Delaware Supreme Court, it would take longer than sixteen days.

130. Like other similar courts, the Delaware Supreme Court is not allowed to give unsolicited, "advisory opinions." See DEL. CONST. art. IV, § 11(8). Thus, the Delaware Supreme Court (or any other court in Delaware) would have to wait for a party to bring an action in order to rule on it.

131. One reason so many courts decide to follow Delaware Corporate Law jurisprudence is due to the internal affairs doctrine. See Faith Stevelman, *Regulatory Competition, Venue and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 1 (2009). The internal affairs doctrine states that a company's choice state of incorporation "effectuates a choice of corporate law that is binding on the corporation and its directors, officers and controlling shareholders. Because of the internal affairs doctrine, even when Delaware corporations or their managers become defendants in out-of-state corporate lawsuits, Delaware's corporate law will govern." *Id.* Consequently, since most publicly traded corporations are housed in Delaware, Delaware's jurisprudence is very significant. See Delaware Dept. of State: Div. of Corp., <http://www.corp.delaware.gov/aboutagency.shtml> (last visited Mar. 1, 2009).

132. See Atkins, *supra* note 4.

133. *Id.*

134. *Id.*

135. *Id.*

136. In fact, Delaware is currently the only State to allow the SEC to certify questions of law to any of its courts. The "old" method would be the one used by the Staff to decide Rule 14a-8 no-action requests made by companies whose state of incorporation is not Delaware.

method of analysis would have come to the wrong conclusion in the *CA, Inc.* no-action request.

Finally, from a policy perspective, other states should give the SEC the ability to certify questions of state law to their respective courts in order to give a proper answer under the federal securities laws. Currently, the SEC is charged with interpreting state law when making a decision under Rules 14a-8(i)(1) and (i)(2). However, with the exception of Delaware, no state allows its courts to hear cases directly from the SEC.<sup>137</sup> Consequently, when the SEC is confronted with a novel question of state law (such as with the *CA, Inc.* no-action request) the SEC's ability to provide the correct answer is severely limited—it must interpret a state's law even though it is not an expert in that state's law.<sup>138</sup> Such a decision is difficult for any type of federal institution, whether it be a court or agency.<sup>139</sup> Thus, other states should follow Delaware's lead and allow the SEC to certify questions of law that arise under federal securities law.<sup>140</sup> By doing so, clear, quick and accurate guidance will be given not only to the SEC, but also to companies and shareholders alike as to what is permissible under the law of their state of incorporation. If a state is truly concerned with its corporate law, then there is no reason for that state to allow the SEC to interpret its corporate law.

## VI. THE AFTERSHOCK OF *CA, INC. V. AFSCME*: THE STATUS OF SHAREHOLDER-ADOPTED BYLAWS AFFECTING CORPORATIONS UNDER DELAWARE LAW

Although the *CA, Inc.* case raises questions of federalism, it is also a landmark case in Delaware corporate law jurisprudence.<sup>141</sup> Although the decision has scholars and commentators debating what exactly the Delaware Supreme Court decided, ultimately the decision will prove to be a victory in name only for shareholders who propose an election-related bylaw amendment; for all other bylaws, the *CA, Inc.* decision is a significant defeat.<sup>142</sup>

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137. See Atkins, *supra* note 4 (stating that the power to certify questions of law to Delaware was a “new method” of deciding Rule 14a-8 issues).

138. See *id.* (stating that part of the SEC's job under Rule 14a-8 is to “resolve issue[s] of state law”).

139. See *Essex Universal Corp. v. Yates*, 305 F.2d 572, 580 (2d Cir. 1962) (Friendly, J., concurring) (stating that the task of a federal court to apply state law is difficult when the jurisprudence on the subject is undeveloped). In reality, a federal agency trying to do the same thing is just as difficult.

140. A state should not necessarily accept certification from the SEC. If state courts are content with having the SEC interpret its laws without more explicit guidance, that is their prerogative.

141. *CA v. AFSCME: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, *supra* note 42.

142. See *id.* (stating that the *CA, Inc.* case “is a very significant decision that will prompt much practitioner commentary and scholarly discussion . . . with implications that will take time and future decisions to work out”).

### A. THE COURT'S OPINION

In order to arrive at a decision, the court had to answer two questions:<sup>143</sup> First, was “the AFSCME proposal<sup>144</sup> a proper subject for action by shareholders as a matter of Delaware law,”<sup>145</sup> and second, “would the AFSCME Proposal . . . cause CA to violate any Delaware law?”<sup>146</sup> Regarding the first question, the court stated that the board of directors and shareholders each have the power to “adopt, amend or repeal bylaws.”<sup>147</sup> However, the court concluded that the shareholders’ power to adopt, amend or repeal bylaws is separate from management’s and “not coextensive with the board’s concurrent power and is limited by the board’s management prerogatives under [s]ection 141(a).”<sup>148</sup> Consequently, the court declared that if the proposal was legal it must be in “the scope or reach of shareholders’ power to adopt, alter or repeal bylaws.”<sup>149</sup> In order to determine shareholders’ power under DGCL section 109(b) versus management’s power under section 141(a), the court had to decide “what is the scope of shareholder action that [s]ection 109(b) permits yet does not improperly intrude upon the directors’ power to manage corporation’s business and affairs under [s]ection 141(a).”<sup>150</sup>

Relying on precedent,<sup>151</sup> the Delaware Supreme Court declared that “procedural bylaws do not improperly encroach upon the board’s managerial authority under [s]ection 141(a).”<sup>152</sup> Since the proposal’s call for mandatory reimbursement would “encourage the nomination of non-management board candidates by promising reimbursement of . . . proxy expenses if one or more candidates [were] elected”<sup>153</sup> and because “[t]he unadorned right to cast a ballot in a contest for [corporate] office . . . is meaningless without the right to participate in selecting the contestants,”<sup>154</sup> the proposal at issue had the “purpose of . . . promot[ing] the integrity of the [director] electoral process by facilitating the nomination of director

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143. *CA, Inc. v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227, 231 (Del. 2008).

144. For purposes of this section, the words “Proposal” and “Bylaw” (when capitalized) are used interchangeably to refer to AFSCME’s proposal.

145. *CA, Inc.*, 953 A.2d at 231.

146. *Id.*

147. *Id.* at 232. The court stated that shareholders find their power from § 109(a), while management finds its power from § 141(a). *See id.* Furthermore, § 109(b) articulates the grant of power given by § 109(a). Consequently, the court’s analysis (and mine) will often refer to § 109(b). *See id.*

148. *Id.*

149. *Id.*

150. *Id.* at 234.

151. *See CA, Inc.*, 953 A.2d at 235 nn.15–16.

152. *Id.*

153. *Id.* at 237.

154. *Id.* (alteration in the original) (*citing* *Harrah’s Entm’t v. JCC Holding Co.*, 802 A.2d 294, 311 (Del. Ch. 2002)).

candidates by stockholders or groups of stockholders.”<sup>155</sup> The court concluded that the proposal’s “substantive-sounding mandate to expend corporate funds, has both the intent and effect of regulating the *process* for electing directors of CA.”<sup>156</sup> Thus, the Delaware Supreme Court determined that the bylaw was a “proper subject for shareholder action,” answering the first question certified to them in the affirmative.<sup>157</sup>

Next, the court had to address whether the bylaw was “inconsistent with law,”<sup>158</sup> specifically, “whether the proposed bylaw, if adopted, would cause CA to violate any Delaware law to which it is subject.”<sup>159</sup> Looking at the proposal abstractly to see if there was at least one hypothetical situation where the proposal would cause the CA board of directors to violate their fiduciary duties to the corporation,<sup>160</sup> and relying on two prior Delaware Supreme Court decisions,<sup>161</sup> the court concluded the bylaw, if adopted, would prevent the CA board of directors from “fully discharging their fiduciary duties to the corporation and shareholders.”<sup>162</sup> Therefore, the court concluded that proposal was illegal.<sup>163</sup>

In *Paramount Communications, Inc. v. QVC Network, Inc.*, the first case relied on, a no-shop provision<sup>164</sup> for a proposed merger was held to be “invalid and unenforceable” because it was tantamount to having the board of directors of the target company<sup>165</sup> contract away their fiduciary duties.<sup>166</sup> Similarly, in *Quickturn Designs Sys., Inc. v. Shapiro*, the second case relied on, a “delayed redemption poison pill”<sup>167</sup> was held to be invalid because it would “deprive a newly elected board of both its statutory authority to manage the corporation under [section 141(a)] and its concomitant fiduciary duty pursuant to that mandate.”<sup>168</sup> Thus, in each case the court invalidated “binding contractual arrangements that the board of directors had

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155. *Id.*

156. *Id.* at 236 (emphasis added).

157. *CA, Inc.*, 953 A.2d at 237.

158. *Id.*

159. *Id.*

160. *Id.* at 238.

161. The two cases the court relied upon are *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994), and *Quickturn Designs Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998). Both cases are discussed *infra*.

162. *CA, Inc.*, 953 A.2d at 238.

163. *Id.* at 240.

164. A no-shop provision prevents a “target company . . . from communicating with competing bidders in an effort to obtain the highest available value for shareholders.” *Id.* at 238.

165. A target company is the company being acquired in a merger. *See id.*

166. *See id.*

167. A delayed redemption poison pill prevents a “newly elected board of directors from redeeming a poison pill” for a certain period of time in hopes of deterring a hostile bidder from waging a proxy contest. *Id.* at 238–39.

168. *CA, Inc.*, 953 A.2d at 238–39.

voluntarily imposed upon themselves” because of the interference it would impose on the board’s fiduciary duties.<sup>169</sup>

Applying a *QVC/Quickturn* analysis, the court concluded the proposal, as written, was illegal because although the bylaw allowed the CA board to “determine what amount to reimburse,” it contained “no language or provision that would reserve to CA’s directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement at all.”<sup>170</sup> Since Delaware law forbids a “board from reimbursing costs incurred where a proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to those of the corporation,”<sup>171</sup> CA would violate its fiduciary duties if the bylaw was adopted.<sup>172</sup> Even if shareholders were the ones making the binding resolution, and not the board of directors like in *QVC* and *Quickturn*, it would be a “distinction without a difference”<sup>173</sup> since the Bylaw would prevent the board of directors from discharging their fiduciary duties properly.<sup>174</sup> Consequently, the second question was answered in the affirmative.<sup>175</sup>

Scholars and commentators immediately took note of the *CA, Inc.* decision, and started to debate what the case actually meant for the future of Delaware corporate law.<sup>176</sup> Furthermore, although the court said the election-related bylaw was permissible as an exercise of shareholders’ power under section 109, it was not attempting to draw a “bright line” rule of when something promulgated under section 109 intrudes upon management’s power in section 141.<sup>177</sup>

## B. COMMENTATORS AND SCHOLARS REACT

The *CA, Inc.* decision has divided commentators and scholars over what it actually means. According to Lisa Fairfax,<sup>178</sup> while a bylaw that contained a fiduciary out clause would “do away with any concern that the implementation of the bylaw would violate Delaware law in the form of compelling directors to act in a manner that violates their [fiduciary duties],”<sup>179</sup> even if such bylaw were valid, directors could now challenge it

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169. *Id.* at 239.

170. *Id.* at 240.

171. *Id.* This is the hypothetical situation alluded to by the Delaware Supreme Court in *CA, Inc.*

172. *See id.* at 240.

173. *Id.* at 239.

174. *CA, Inc.*, 953 A.2d at 239.

175. *Id.* at 240.

176. *See* sources cited *supra* note 42.

177. *CA, Inc.*, 953 A.2d at 234 n.14.

178. Lisa Fairfax, Professor of Law, Univ. of Maryland Sch. of Law, <http://www.law.umaryland.edu/faculty/profiles/faculty.html?facultyid=044>.

179. What’s Next for Shareholder Advocates? (July 21, 2008), <http://www.theconglomerate.org/2008/07/page/4/>.

by “allowing directors to challenge payment of expenses for every successful candidate.”<sup>180</sup> Since “the potential for protracted litigation over such questions . . . makes reimbursement uncertain,”<sup>181</sup> it is possible that [the] “bylaw’s purpose of facilitating more nominees [is undermined].”<sup>182</sup> Professor Brown echoes Ms. Fairfax’s views, adding that while there was “no language in the bylaw [pertaining to a fiduciary out clause,] there didn’t have to be [because] [u]nder Delaware law, a board confronted with the possibility of an illegal payment could have undone the bylaw in its entirety. In other words, the fiduciary out was in the statute.”<sup>183</sup>

However, not all commentators look at the *CA, Inc.* opinion so bleakly. J.W. Verret<sup>184</sup> argues that this decision is “a measured victory for shareholder activist[s] . . . [because] [t]here is a good chance that a Board’s decision to withhold reimbursement through claims that its fiduciary duty requires it would be subject to heightened review . . . since the [c]ourt has accepted that this bylaw is intimately connected with the election process.”<sup>185</sup> Larry Ribstein<sup>186</sup> answers those who believe the *CA, Inc.* decision is a severe blow to shareholder activism by asserting the court will not “use its power to negate shareholder rights . . . . The [c]ourt made it clear that it was not deciding the issue as a matter of policy . . . . Thus, the [c]ourt was careful to present itself as a pragmatic forum that would hear shareholders’ arguments on a case by case basis.”<sup>187</sup> Similarly, another commentator argues that “the case [is] . . . a significant win . . . [because] the [c]ourt held that the election process was a proper subject for stockholder action. A bylaw mandating the inclusion of stockholder nominees on the company’s proxy statement should fare much better under a *CA, Inc.* analysis.”<sup>188</sup>

Outside of election-related bylaws, commentators and scholars generally feel that the *CA, Inc.* opinion leaves little room for shareholders to affect a corporation via the bylaw amendment process because of the

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180. *Id.*

181. *Id.*

182. *Id.*

183. As Predicted: The SEC and the Further Denial of Shareholder Access (The Actual Result) (Part 19), <http://www.theracetothetbottom.org/the-sec-governance/as-predicted-the-sec-and-the-further-denial-of-shareholder-a-46064.html> (July 18, 2008, 9:00 AM).

184. See J.W. Verret, Assistant Professor of Law, George Mason Univ. Sch. of Law, [http://www.law.gmu.edu/faculty/directory/verret\\_jw](http://www.law.gmu.edu/faculty/directory/verret_jw).

185. ProfessorBainbridge.com, Commentary on *CA v AFSCME*, <http://www.professorbainbridge.com/> (July 18, 2008) (follow “Archive (Calendar) hyperlink; then follow “Previous Year” hyperlink; then follow “July” hyperlink; then follow “Commentary on *CA v AFSCME*” hyperlink). Furthermore, Professor Stephen Bainbridge agrees with this view. See *id.* (stating that [such] views are “probably right”).

186. See Larry Ribstein, Professor of Law at the Univ. of Illinois at Urbana-Champaign, <http://www.law.uiuc.edu/faculty-admin/directory/LarryRibstein>.

187. Ribstein, *Delaware Responds*, *supra* note 42.

188. *CA v. AFSCME*: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away, *supra* note 42.

*QVC/Quickturn* analysis that the court used. Professor Brown asserts that, due to the *CA, Inc.* opinion, “[b]ylaws requiring boards to undertake steps to curb global warming, . . . or to withdraw poison pills . . . [will] be on their face invalid [since they are not procedural] . . . . The [c]ourt used the case to dramatically broaden the types of bylaws that now must be excluded under Rule 14a-8.”<sup>189</sup> This viewpoint is also asserted by another commentator who says, “[o]utside the election process, the case is generally negative for stockholder-adopted bylaws. For example, the strong *QVC/Quickturn* analysis should doom any substantive component to a pill redemption bylaw, such as a requirement that directors not adopt or renew any pill that could be in place longer than a year.”<sup>190</sup> However, some commentators posit that the future implications of the *CA, Inc.* case are unknown<sup>191</sup> because the “court deliberately leaves us with little clarity and certainty as to how to discern whether a given bylaw is one that is process-related [and thus valid] . . . or is one that by mandating the decision is necessarily substantive and, therefore, would be invasive of the managerial prerogatives of the board.”<sup>192</sup> Therefore, the views of the *CA, Inc.* opinion amongst experts in the corporate law and governance field are divided at best.

### C. THE FUTURE IMPLICATIONS OF *CA, INC. v. AFSCME*

The effects of the *CA, Inc.* case can be analyzed as in two distinct categories: bylaws that affect election-related processes, and bylaws that affect the board of directors’ substantive decision making process. Concerning the first category, the *CA, Inc.* case is a victory in name only. While it is true that a bylaw similar to the one AFSCME proposed (that contains a fiduciary-out clause) is now valid, the board of directors have the power to object to corporate expenses.<sup>193</sup> The mandatory reimbursement feature for a short slate of directors made this bylaw unique. However, a

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189. As Predicted: The SEC and the Further Denial of Shareholder Access (The Actual Result) (Part 18), *supra* note 183.

190. *CA v. AFSCME: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, *supra* note 42.

191. See Genkin & Gottfried, *supra* note 42 (stating that the court avoided “articulating with ‘doctrinaire exactitude’ a bright line that divides those bylaws that shareholders may unilaterally adopt from those which they may not since they would encroach upon the board’s power and authority to manage the business and affairs of the company”). See also *CA v. AFSCME: The Delaware Supreme Court Giveth and the Supreme Court Taketh Away*, *supra* note 42 (stating that in the “unforeseen consequences department, directors may find that the *CA* decision’s broad extension of a fiduciary trump card causes more problems than it solves. Under the *CA* analysis, mandatory bylaws may no longer be mandatory. They rather appear to be subject to the directors’ overarching fiduciary duties. Directors who take action in reliance on a mandatory bylaw therefore can now be second-guessed on fiduciary duty grounds.”).

192. See Genkin & Gottfried, *supra* note 42.

193. See *CA, Inc. v. Am. Fed’n of State, County & Mun. Employees Pension Plan*, 953 A.2d 227, 240 (Del. 2008).

fiduciary-out clause makes the mandatory reimbursement provision useless. The fear of protracted litigation that Ms. Fairfax expresses is a very real situation that is quite likely to occur. Fear that proxy expenses will not be reimbursed will act as a deterrent towards those who have an inclination to nominate their own short slate of directors.

Although the court's broad interpretation of the AFSCME bylaw as a process-oriented bylaw is a victory for shareholders, it will be a victory with no consequences unless the Delaware courts (or legislature) either (i) expressly excepts a short slate's mandatory reimbursement of proxy expenses from fiduciary duties or (ii) allow shareholders to be compensated or significantly penalizes corporations for bringing fiduciary-out lawsuits that do not win. Without such deterrents, corporations have little, if any reason not to challenge a reimbursement of proxy expenses from corporate funds in a short-slate proxy contest.

Outside of the election-related bylaw amendments, the *CA, Inc.* decision is a significant defeat for shareholders who wish to impinge upon power generally reserved to the board of directors, such as the right to redeem poison pills or to determine where the board invests the corporations' money. By using the *QVC/Quickturn* analysis, the court reaffirmed that only a corporations' board of directors has the power to decide how "specific substantive business decisions" are made.<sup>194</sup> On a certain level, such a decision makes sense because the corporation is run by professional managers (i.e. the board of directors). Consequently, why should their determinations be questioned by passive investors (shareholders)?<sup>195</sup>

Although Professor Brown believes the Commission was wrong for certifying the questions it did to the Delaware Supreme Court, he believes "the Delaware Supreme Court[']s . . . reasoning . . . will allow companies to challenge even more proposals submitted under Rule 14a-8. [This] will, ultimately, put pressure on the Commission to sidestep the anti-shareholder nature of Delaware law and allow access to the company's proxy statement," a result which is the goal of every shareholder activist.<sup>196</sup> While such a proposition is intriguing, and if it came to fruition, would make the *CA, Inc.* opinion "largely irrelevant,"<sup>197</sup> it is not the state of Delaware

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194. *Id.* at 235.

195. See generally ProfessorBainbridge.com, *CA v. AFSCME: The Limits of Shareholder Power* (July 17, 2008), (follow "Archive (Calendar) hyperlink; then follow "Previous Year" hyperlink; then follow "July" hyperlink; then follow "CA v. AFSCME: The Limits of Shareholder Power" hyperlink).

196. As Predicted: The SEC and the Further Denial of Shareholder Access (The Actual Result) (Part 17), <http://www.theracetothetbottom.org/the-sec-governance/as-predicted-the-sec-and-the-further-denial-of-shareholder-a-48788.html> (July 18, 2008, 06:15 AM).

197. As Predicted: The SEC and the Further Denial of Shareholder Access (The Actual Result) (Part 21), <http://www.theracetothetbottom.org/the-sec-governance/as-predicted-the-sec-and-the-further-denial-of-shareholder-a-47850.html> (July 18, 2008, 12:00 PM).



corporate law as we know it today. Furthermore, while the Delaware Supreme Court did not announce with “doctrinal exactitude” the scope of section 109’s power versus section 141, such language should be viewed as a defensive measure taken by the court to protect itself, rather than as language to support optimistic shareholder activists.<sup>198</sup> Therefore, the impact of shareholders to intrude upon the power of management, at least in the near future, will be minimal at best.

## VII. CONCLUSION

The *CA, Inc.* case raises interesting questions of federalism and the limits of shareholder activism. Regarding the issue of federalism, the SEC was correct to certify the questions to Delaware because corporate law is not an issue for the federal government to decide. Corporate law is a state issue, and thus, when a method exists for the federal government to decide an issue about a certain aspect of corporate law with certainty, it must.

With respect to the substantive decision behind the *CA, Inc.* case, the opinion can be seen as a victory in name only with respect to election-related bylaws and a complete defeat in all other areas. The Delaware Supreme Court was clear that the ultimate authority to make decisions remains with the board, and while the court did say that a proposal like AFSCME’s would be valid if it contained a fiduciary-out clause, it is that requirement that will probably scare away activists from trying to wage a proxy war when a short slate of candidates is involved. As a result, the Delaware Supreme Court’s *CA, Inc.* decision reaffirmed many people’s view of it as a “director-centric” court.<sup>199</sup>

*Joseph Antignani\**

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198. This observation is made by looking at the rest of the *CA, Inc.* opinion, in which the court uses pro-management cases to support its decision.

199. *CA v. AFSCME: The Limits of Shareholder Power*, *supra* note 195.

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